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In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-375

WILLIAM OTTE, TRUSTEE IN BANKRUPTCY OF FREEDOMLAND, INC., PETITIONER

v.

UNITED STATES OF AMERICA, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court (A. 70a–91a) is reported at 341 F. Supp. 647. The opinion of the court of appeals (A. 5a–17a) is reported at 480 F. 2d 184.

JURISDICTION

The judgment of the court of appeals was entered on June 8, 1973. The petition for a writ of certiorari was filed on August 29, 1973, and was granted on January 21, 1974. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether a trustee in bankruptcy must withhold federal income and FICA taxes from payment of wage claims made under Section 64a(2) of the Bankruptcy Act and prepare and submit to the wage claimants and the Internal Revenue Service appropriate information reports and returns with respect to the amounts withheld.

2. Whether the United States is required to file a proof of claim with respect to withholding taxes on priority wage claims.

3. Whether withholding taxes on priority wage payments constitute first, second, or fourth priority debts under Section 64a of the Bankruptcy Act.

STATUTES INVOLVED

Sections 57, 63 and 64 of the Bankruptcy Act, as amended, 11 U.S.C. 93, 103, and 104, provide in pertinent part as follows:

> Section 57a. A proof of claim shall consist of a statement, in writing and signed by a creditor, setting forth the claim; the consideration therefor; whether any and, if so, what securities are held therefor; and whether any and, if so, what payments have been made thereon; and that the claim is justly owing from the bankrupt to the creditor. A proof of claim filed in accordance with the requirements of [the Bankruptcy Act], the General Orders of the Supreme Court, and the official forms, even though not verified under oath, shall constitute prima facie evidence of the validity and amount of the claim.
>
> * * * * *

j. Debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.

* * * * *

n. Except as otherwise provided in this Act, all claims provable under this [Act], including all claims of the United States and of any State or any subdivision thereof, shall be proved and filed in the manner provided in this section. * * *

* * * * *

Section 63a. Debts of the bankrupt may be proved and allowed against his estate which are founded upon * * * (8) contingent debts and contingent contractual liabilities; * * *.

* * * * *

Section 64a. The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be

(1) the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition; * * *

(2) wages and commissions, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen, servants, clerks, or traveling, or city salesmen on

> salary or commission basis, whole or part time, whether or not selling exclusively for the bankrupt; * * *
>
> (4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy * * *.
>
> * * * * *

Sections 3101, 3102, 3121, 3401, 3402, 3403, 6001, 6011, and 6051 of the Internal Revenue Code of 1954, as amended, 26 U.S.C. 3101, 3102, 3121, 3401, 3402, 3403, 6001, 6011, and 6051, provide in pertinent part as follows:

> Section 3101. (a) In addition to other taxes, there is hereby imposed on the income of every individual [an old-age, survivors, and disability insurance] tax * * *.
>
> * * * * *
>
> Section 3102. (a) The tax imposed by section 3101 shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid. * * *
>
> (b) Every employer required so to deduct the tax shall be liable for the payment of such tax * * *.
>
> * * * * *
>
> Section 3121. (a) For purposes of this chapter, the term "wages" means all remuneration for employment * * *.
>
> (b) For purposes of this chapter, the term "employment" means * * * any service, of whatever nature, performed * * * by an employee for the person employing him * * *.
>
> * * * * *

Section 3401. (a) For purposes of this chapter [relating to withholding of income taxes], the term "wages" means all remuneration * * * for services performed by an employee for his employer * * *.

(d) For purposes of this chapter, the term "employer" means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that—

(1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer" (except for purposes of subsection (a)) means the person having control of the payment of such wages * * *.

* * * * *

Section 3402. (a) Every employer making payment of wages shall deduct and withhold upon such wages [an income] tax.

* * * * *

Section 3403. The employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter * * *.

* * * * *

Section 6001. Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary or his delegate may from time to time prescribe. * * *

* * * * *

Section 6011. (a) When required by regulations prescribed by the Secretary or his delegate any person made liable for any tax imposed by this title, or for the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary or his delegate. Every person required to make a return or statement shall include therein the information required by such forms or regulations.

* * * * *

Section 6051. (a) Every person required to deduct and withhold from an employee a tax under section 3101 or 3402, * * * shall furnish to each such employee in respect of the remuneration paid by such person to such employee during the calendar year, on or before January 31 of the succeeding year, or, if his employment is terminated before the close of such calendar year, on the day on which the last payment of remuneration is made, a written statement showing the following:

(1) the name of such person,

(2) the name of the employee (and his social security account number if wages as defined in section 3121(a) have been paid),

(3) the total amount of wages as defined in section 3401(a),

(4) the total amount deducted and withheld as tax under Section 3402,

(5) the total amount of wages as defined in section 3121(a), and

(6) the total amount deducted and withheld as tax under section 3101 * * *.

* * * * *

(d) A duplicate of any statement made pursuant to this section and in accordance with regulations prescribed by the Secretary or his delegate shall, when required by such regulations, be filed with the Secretary or his delegate.

STATEMENT

Freedomland, Inc. filed a petition for an arrangement under Chapter XI of the Bankruptcy Act, 11 U.S.C. 701 *et seq.*, on September 15, 1964. The arrangement failed, and Freedomland was adjudicated a bankrupt on August 30, 1965. Petitioner was appointed trustee in bankruptcy (A. 27a).

During the six-month statutory period for filing proofs of claims against the bankrupt estate (see Sections 57 and 63 of the Bankruptcy Act, 11 U.S.C. 93 and 103), 413 former employees of Freedomland filed proofs of claims for unpaid wages, aggregating approximately $80,000, that had been earned prior to the filing of the Chapter XI petition and for which the employees were entitled to priority of payment under Section 64a(2) of the Act (A. 72a). The United States did not file proofs of claims for the income and FICA taxes which would arise upon the payment of those priority wage claims, on the theory that those taxes were not "[d]ebts of the bankrupt" under Section 63 of the Act.

Under Internal Revenue Service directives, a trustee in bankruptcy, upon paying priority wage claims, has the option of withholding income and FICA taxes at either a combined flat rate of 25 percent or at the rates prescribed by Sections 3101 and

3402 of the Internal Revenue Code of 1954, 26 U.S.C. 3101 and 3402 (see A. 29a). Petitioner, however, contended before the bankruptcy referee that the 25 percent rate would result in substantial over-withholding and that determination of the exact amounts due, plus compliance with the reporting requirements of the Code, would involve "a massive burden" (A. 31a). The referee agreed with petitioner that the withholding and reporting requirements of the Code "impose a * * * burden on the administration of [bankrupt] estates which is entirely inconsistent with the objective of efficient expeditious economic administration * * *" (A. 36a). The referee accordingly authorized petitioner to pay the wage claims without any withholding for taxes and further held that petitioner was not required to pay over to the United States any income or FICA taxes, to file any returns with the Internal Revenue Service, or to provide any reports to the employees or the Service with respect to the payment of the wage claims (A. 48a–50a).

The United States appealed to the United States District Court for the Southern District of New York. After a hearing, the district court concluded that only a simple bookkeeping effort would be involved in withholding 25 percent of the wage distributions and in complying with the reporting requirements of the Code. The court then held, relying principally upon *United States* v. *Fogarty*, 164 F. 2d 26 (C.A. 8), that a trustee in bankruptcy must withhold and pay over income and FICA taxes out of priority wage payments and prepare and submit the appropriate

information reports and returns. The court further held that such taxes are not expenses of administration entitled to first priority under Section 64a(1) of the Act but rather are "taxes which became legally due and owing by the bankrupt" and therefore entitled only to fourth priority under Section 64a(4). Finally, the court held that prior proofs of claims need not be filed with respect to such taxes, because the employees' proofs of claims with respect to their prebankruptcy wages fully apprise the trustee and other creditors of the total amounts that will be distributable, as wages and taxes, on account of such claims.

The court of appeals affirmed as to petitioner's obligation to withhold and pay over the income and FICA taxes and to prepare and submit the appropriate reports and returns. The court also affirmed the district court's conclusion that no proofs of claims were required with respect to such withholding taxes. The court of appeals disagreed, however, with the district court's holding that the government's claim for the withholding taxes was entitled only to a fourth priority. The court reasoned that since those taxes could not have been determined at the date of bankruptcy they were not "legally due and owing by the bankrupt" within the meaning of Section 64a(4). The court concluded that withholding taxes "should be treated in the same way as the wages from which they derive" (A. 15a), *i.e.*, as second-priority items under Section 64a(2) of the Act.

SUMMARY OF ARGUMENT

I

The Internal Revenue Code requires trustees in bankruptcy to withhold federal income and FICA taxes from payments of wage claims made under Section 64a(2) of the Bankruptcy Act and to prepare and submit to the wage claimants and the Internal Revenue Service appropriate information reports and returns with respect to the amounts withheld.

Federal income tax withholding is required of every "employer" making payment of "wages." The term "wages" covers all remuneration for employment services, and the Secretary's regulations have long expressly provided that "[r]emuneration for services * * * constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them." 26 C.F.R. 31.3401(a)–1(a)(5). The payment of wage claims in bankruptcy is therefore the payment of "wages" for income tax withholding purposes. Similarly, Section 3401(d)(1) of the Code specifies that when the common-law employer has lost control of the payment of wages, "the person having control of the payment of such wages" is responsible for withholding. Petitioner, as the person who controls the payment of wage claims, is therefore the "employer" responsible for withholding the tax.

The argument is substantially the same for the FICA tax. But an additional consideration with respect to that tax is that the wage payments are

"wages" for Social Security Act purposes, and withholding and reporting are necessary to ensure that the employee's account is properly credited and that the United States receive the payment necessary to fund that credit.

It is undisputed that petitioner must comply with the withholding tax reporting requirements of the Code if he is required to withhold. These reporting requirements are not seriously burdensome, and are in any event valid federal statutory requirements.

II

The United States is not required to file proofs of claims with respect to withholding taxes on priority wage claims.

Formal proof is required only of debts from which the bankrupt is released by a discharge in bankruptcy. Thus only debts of the bankrupt are "provable" in bankruptcy; proofs of claims need not be filed with respect to the separate debts of the estate. The withholding taxes here arise only upon payment of the wage claims by petitioner on behalf of the estate; accordingly, they arise as debts of the estate, not of the bankrupt.

Moreover, the filing of formal proofs of claims with respect to withholding taxes on priority wage claims is impracticable, for the taxes are not computable until the amount of wages to be paid and the tax rate in effect at the time of payment are both known. In any event, such filings would serve no purpose under the Bankruptcy Act, for the filings of proofs of priority wage claims adequately apprise

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all parties of the total amounts, including withholding taxes, that may be payable out of the estate on account of such claims.

III

Withholding taxes on priority wage payments are first priority debts under Section 64a of the Bankruptcy Act.

Since the taxes are payable out of the employees' share of the estate, and the employees receive appropriate federal income tax and Social Security credits on account of those taxes, no creditors are harmed by payment of the taxes as priority debts. In contrast, treatment of the taxes as general unsecured claims would confer an unjustifiable windfall upon other creditors in many cases.

The withholding taxes that arise upon payment of priority wage claims in bankruptcy are necessary costs incurred in the course of administering the estate and as such are "costs and expenses of administration" entitled to first priority of payment. The fact that these taxes do not contribute to the "preservation" of the estate is irrelevant under the Act; it is well established that a wide variety of administrative expenses, bearing no relationship to the preservation of the estate, are entitled to first-priority treatment.

First-priority treatment is the only means of assuring that the withholding taxes will be paid in full once collected, and it is the only administratively feasible treatment of such taxes. In contrast, second-priority treatment in some instances would result in nonpayment of the tax and entail far greater com-

plexity in calculating distributions. Moreover, second-priority treatment under the Act is reserved for "wages * * * due to workmen," and the claim of the United States here is not for wages but for taxes that arise in the course of administering the estate.

ARGUMENT

This case involves the treatment of withholding taxes on the payment of priority wage claims under Section 64a(2) of the Bankruptcy Act, *i.e.*, on wages earned before but paid after bankruptcy. But the issues raised here may be placed in perspective by first considering the treatment of withholding taxes on wages in two other common bankruptcy situations.

When the wages in question are both earned and paid prior to bankruptcy, it is undisputed that the employer is required to withhold both income and FICA taxes under Sections 3402 and 3102 of the Internal Revenue Code. If the employer at the time of making payment properly segregates the withholding taxes in a trust fund pursuant to Section 7501 of the Code, in our view that fund would be separately payable to the United States notwithstanding any intervening bankruptcy; it would not become part of the bankrupt estate. See *Nicholas* v. *United States*, 384 U.S. 678, 690–691; *United States* v. *Randall*, 401 U.S. 513, 515. If the employer had failed to segregate withholding taxes prior to bankruptcy, the trustee in bankruptcy would nevertheless be obligated to pay over those taxes to the United States as a fourth-priority item under Section 64a(4) of the Bankruptcy Act, relating to "taxes which became legally due and

owing by the bankrupt." Since such taxes are "[d]ebts of the bankrupt" within the meaning of Section 63 of the Act, the United States is required to file proofs of claims with respect to those taxes under Section 57.

It is similarly undisputed that the trustee in bankruptcy is required to withhold income and FICA taxes on wages that are both earned and paid after bankruptcy. Those taxes are payable to the United States either as a special trust fund under Section 7501 of the Code or as a cost and expense of administration under Section 64a(1) of the Act. See *Boteler* v. *Ingels*, 308 U.S. 57; *Nicholas* v. *United States*, *supra*. Since such taxes are not obligations of the debtor in bankruptcy, no proof of claim is required under Section 57 of the Act. See 3A Collier, *Bankruptcy*, ¶ 63.03, n. 1.[1]

In either case the person or persons responsible for withholding the taxes and for paying them over to the United States is required under Sections 6001, 6011, and 6051 of the Code, to furnish appropriate information reports and returns to the Internal Revenue Service and the employees whose wages are subject to withholding.

Petitioner contends that the circumstances of this case are uniquely different—that when wages earned before but paid after bankruptcy are involved, the trustee in bankruptcy is excused from the withholding and reporting requirements under the Code. Petitioner further contends that even if the trustee is required to withhold and report such taxes, they con-

[1] All references to Collier are to the 14th edition.

stitute "[d]ebts of the bankrupt" which are payable only if the United States has filed prior proofs of claims. Petitioner finally contends that at best such taxes are payable only as nonpriority items. We turn now to a discussion of these contentions.

I

A TRUSTEE IN BANKRUPTCY MUST WITHHOLD FEDERAL INCOME AND FICA TAXES FROM PAYMENTS OF WAGE CLAIMS MADE UNDER SECTION 64a(2) OF THE BANKRUPTCY ACT AND PREPARE AND SUBMIT TO THE WAGE CLAIMANTS AND THE INTERNAL REVENUE SERVICE APPROPRIATE INFORMATION REPORTS AND RETURNS WITH RESPECT TO THE AMOUNTS WITHHELD

Every court of appeals before which the question has been raised, including the court below, has concluded that the Internal Revenue Code requires trustees in bankruptcy to withhold federal income and FICA taxes from payments of wage claims made under Section 64a(2) of the Bankruptcy Act and to prepare and submit to the wage claimants and the Internal Revenue Service appropriate information reports and returns with respect to the amounts withheld. *United States* v. *Fogarty*, 164 F. 2d 26 (C.A. 8); *United States* v. *Curtis*, 178 F. 2d 268 (C.A. 6), certiorari denied, 339 U.S. 965; *In re Connecticut Motor Lines*, 336 F. 2d 96 (C.A. 3). See also, *Lines* v. *California Department of Employment*, 242 F. 2d 201 (C.A. 9), certiorari denied, 355 U.S. 857. As we now show, these decisions rest upon a sound statutory basis and do not result in the imposition of an undue burden on the administration of bankrupt estates.

A. THE INTERNAL REVENUE CODE REQUIRES THE WITHHOLDING OF FEDERAL INCOME AND FICA TAXES FROM PRIORITY WAGE CLAIM PAYMENTS AND THE SUBMISSION OF INFORMATION REPORTS AND RETURNS WITH RESPECT TO THE AMOUNTS WITHHELD

1. Sections 3402 and 3102 of the Internal Revenue Code require a trustee in bankruptcy to withhold Federal income and FICA taxes from priority wage claim payments

a. *Income tax withholding.* Withholding of federal income taxes is required by Section 3402 of the Code, which provides that "[e]very employer making payment of wages shall deduct and withhold upon such wages * * * a tax determined in accordance with the [withholding tax] tables." Petitioner contends (Br. 8–11) that the payment of priority wage claims does not constitute the payment of "wages," and that the trustee in bankruptcy is not the "employer" of the wage claimants, within the meaning of that provision.

(1) Section 3401(a) broadly defines the term "wages" for income tax withholding purposes as "all remuneration * * * for services performed by an employee for his employer." The payments here are being made as remuneration for the services performed by the wage claimants, as employees, for their former employer, Freedomland, Inc., before its bankruptcy. See Section 3401(c) and (d) (defining "employee" and "employer"). Petitioner contends, however, that the statutory definition of "wages" does not cover remuneration for prior employment made after termination of the employment relationship. This contention is inconsistent with the statutory text and directly contrary to the long-standing administrative construction.

Section 3401(d) defines "employer," at least for purposes of the definition of "wages" under Section 3401(a) (see the parenthetical exception in Section 3401(d)(1)), as "the person for whom an individual *performs or performed* any service" (emphasis added). We believe that Congress used both present and past tenses ("performs or performed") in the alternative in order to specify that the characterization of a payment as "wages" is not dependent upon the existence of a continuing employment relationship. This has long been the Secretary's construction. The income tax withholding regulations since 1943 have provided that "[r]emuneration for services * * * constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them." 26 C.F.R. 31.3401(a)-1(a)(5). See Sections 404.101 of Treasury Regulations 115, 405.105 of Treasury Regulations 116 (1944 & 1951 eds.), and 406.205 of Treasury Regulations 120, all under the 1939 Code. Petitioner suggests no reason why these regulations should not apply here.[2]

[2] Petitioner principally relies upon Rev. Rul. 69-136, 1969-1 Cum. Bull. 252, and Rev. Rul. 55-520, 1955-2 Cum. Bull. 393. The issue involved in those rulings, however, was not whether remuneration for prior employment constituted "wages" but rather whether the payments there in question had been made as "[r]emuneration for services" or for some other reason. They therefore do not support petitioner's contention that post-termination wage payments are not subject to withholding. Nor does *United States* v. *Embassy Restaurant*, 359 U.S. 29, upon which petitioner also relies, support that contention. *Embassy Restaurant* (as well as a later, similar case, *Joint Industry*

The Secretary's regulations conform with the plain language of the statute and further the underlying congressional purpose of providing for the collection of income taxes on employment income at the source. They are reasonable and should be sustained. See, *e.g.*, *Cammarano* v. *United States*, 358 U.S. 498.[3]

(2) Section 3401(d)(1) provides that "if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term 'employer' (except for purposes of [the definition of 'wages' under] subsection (a)) means the person having control of the payment of such wages." Petitioner concedes the applicability of that provision, but he contends that the bankruptcy referee's participation in the payment of wage claims is such that it is the referee, rather than the trustee, who has "control of the payment of such wages." There are of course legal constraints on the trustee's power to distribute the assets of the estate; he must secure the prior order and countersignature

Board v. *United States*, 391 U.S. 224) involved the question whether certain payments constituted "wages" within the meaning of Section 64a(2) of the Bankruptcy Act. No such question arises in this case: petitioner, by applying for an order authorizing payment of the employees' claims here, has conceded that those claims are for "wages" for the purposes of that Act. Indeed, if, as petitioner seems to suggest by his reliance on *Embassy Restaurant*, the Bankruptcy Act definition of "wages" governs this case, the priority wage payments here are *a fortiori* subject to withholding.

[3] Moreover, the regulations presumably were approved and adopted by Congress in enacting the same substantive withholding provisions into the 1954 Code. See, *e.g.*, *Lykes* v. *United States*, 343 U.S. 118, 127; *Helvering* v. *Winmill*, 305 U.S. 79, 82–83.

of the referee before making payment of claims. See Section 39a(5) of the Act. Yet the trustee is responsible for recommending allowance or disallowance of claims and for making actual payment (see Section 47a(8) and (11)) as well as for administering the bankrupt estate. See generally 2 Collier, *Bankruptcy*, ¶ 47. We do not believe that the referee's responsibility for overseeing the general administration of the estate deprives the trustee of "control of the payment of such wages" within the meaning of Section 3401 (d)(1), which is primarily concerned with the practical question of who is in a position to withhold the tax. Cf. *King* v. *United States*, 379 U.S. 329.[4] "The purpose is to treat the actual payor of the remuneration as the employer for withholding and payment purposes." *United States* v. *Fogarty, supra*, 164 F. 2d at 32.

But petitioner's argument also fails for a more fundamental reason. If, as petitioner contends, the referee controls the payment of wages for withholding purposes (or if the referee and trustee jointly exercise "control"), the wage payments would nevertheless remain subject to withholding. The referee, as the "employer," would be under a duty to order the trustee to withhold the tax. As the court of appeals

[4] Since petitioner exercises "control of the payment of * * * wages" in a representative rather than personal capacity, we believe that, as a technical matter, it is correct to view the estate and not the trustee as the "employer." Under this view, petitioner's duty to withhold derives from his fiduciary responsibility for administration of the estate, which is itself the "employer." This is also the rule when employees are hired by the trustee to perform services for the estate. 26 C.F.R. 31.3401(d)-1(c); Rev. Rul. 69-657, 1969-2 Cum. Bull. 189.

stated in *United States* v. *Fogarty, supra,* 164 F. 2d at 32:

> The result would be no different if it is argued that the bankruptcy court rather than its trustee is "the person having control of the payment of such wages." There is no provision excepting a court from the requirement of withholding on amounts paid an employee * * *.

b. *FICA Withholding.* The withholding of FICA taxes is governed by provisions that are virtually identical in substance to those just discussed, and petitioner does not separately argue the question of FICA withholding. We set forth here only the considerations that specially pertain to the FICA tax.

Section 3102(a) of the Code provides that the FICA tax "shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid." The wage payments here are clearly "wages" for the purpose of that provision. As is the case with income tax withholding (see p. 17, *supra*), the Secretary's FICA withholding regulations have provided since the early 1940's that "[r]emuneration for employment * * * constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them." 26 C.F.R. 31.3121(a)–1(i). See Sections 402.227(a) of Treasury Regulations 106, and 408.266(a) of Treasury Regulations 128, both under the 1939 Code. This conforms with the

treatment of such wage payments under the Social Security Act. See 20 C.F.R. 404.1026(a)(9).

The FICA withholding provisions of the Code do not specifically define the term "employer." There is, however, no reason for giving that term a narrower construction under the FICA withholding provisions than it has for income tax withholding purposes. The FICA withholding provisions were intended to be construed *in pari materia* with the Social Security Act: the wages that give rise to a credit under that Act must be subject to withholding (and also to the reporting requirements of the Code; see p. 22, *infra*) in order for the employee's account to be properly credited and for the United States to receive the payment necessary to fund the credit. See H. Rep. No. 615, 74th Cong., 1st Sess., pp. 21, 32. And those "taxing provisions are concerned with the character of the payments as wages rather than with the relationship of the payor to the payee * * *." *United States* v. *Fogarty, supra,* 164 F. 2d at 30. The payments here were "wages" within the meaning of the Social Security Act. 20 C.F.R. 404.1026(a)(9). Cf. *Social Security Board* v. *Nierotko,* 327 U.S. 358. They are therefore subject to withholding. Petitioner, as the person responsible for making the wage payments, should be treated as the "employer" within the meaning of Section 3102. Cf. S.S.T. 199, 1937–2 Cum. Bull. 405 (Question 5).

2. Information reports and returns must be submitted with respect to withheld Federal income and FICA taxes

Section 6051(a) of the Code provides that every person required to deduct and withhold federal income or FICA taxes must furnish the employee with a written statement showing the total amount of wages subject to withholding and the amounts deducted and withheld on account of each tax. A duplicate copy of this statement must be filed with the Internal Revenue Service. See Section 6051(d). Sections 6001 and 6011 further require every person liable for payment or collection of a tax to keep such records, render such statements, and make such returns as the Secretary prescribes.

Applicable Treasury Regulations promulgated pursuant to those provisions require persons liable for withholding to furnish the Service (on Forms W–2, W–3, and 941)[5] with the names and Social Security numbers of their employees and the amounts of gross wages paid, taxable FICA wages paid, and federal income and FICA taxes withheld, as to each. See 26 C.F.R. 31.6001–2, 31.6001–5, 31.6011(a)–6(a)(1), and 31.6051–1; Rev. Proc. 71–18, 1971–1 Cum. Bull. 684.

It is undisputed that petitioner must comply with these provisions if he is subject to the withholding requirements of Sections 3402 and 3102.

[5] Copies of these forms are being lodged with the Clerk of this Court.

B. THE COSTS OF COMPLYING WITH THE WITHHOLDING AND REPORTING REQUIREMENTS OF THE CODE DO NOT JUSTIFY A REFUSAL TO COMPLY

Throughout this litigation, petitioner's principal stated objection to complying with the withholding and reporting requirements of the Code has been that compliance is costly. This objection is wholly without merit. The actual costs of compliance are insubstantial, and those costs are in any event irrelevant to the issue of petitioner's statutory obligation to comply.

The bankruptcy referee, without taking any evidence on the subject, asserted that compliance with the withholding and reporting requirements entails a burden that "is entirely inconsistent with the objective of efficient expeditious economic administration of bankrupt estates" (A. 36a). This assertion apparently was based solely on an article written by another bankruptcy referee, which cites no evidence other than that referee's personal knowledge of one instance where it cost an estate approximately $600 to comply with all withholding and reporting requirements (see A. 38a–47a). The district court, upon review of the referee's order, took evidence with respect to the costs of compliance. After summarizing the evidence (A. 77a–81a), the court concluded that "[c]ompliance with [the withholding and reporting] requirements adds only slightly to the trustee's inescapable task and cost of verifying each claim before payment" (A. 81a).[6]

[6] Petitioner contends (Br. 20–22) that the district court should have affirmed the referee's ruling as not clearly erroneous. The "clearly erroneous" standard, however, applies only to "findings of fact" (Rule 810, Rules of Bankruptcy Procedure) and the ref-

The district court was clearly correct in its evaluation of the nature of the burden imposed by the withholding reporting requirements. For those trustees who elect to withhold at the flat 25 percent rate, the necessary withholding tax computations are elementary.[7] For other trustees, the computations involved are merely those that would have been required of the employer prior to bankruptcy, and that are required of all employers in the ordinary course of business. Nor is preparation of the necessary reports and returns costly or difficult. The applicable forms (W-2, W-3, and 941) request only information that should be readily available to the trustee.[8] As the district court found, these "forms can

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eree made no such findings. Under the circumstances, we believe the district court acted properly in taking evidence in order to become informed "as to what burdens are in fact imposed" (A. 77a).

[7] Petitioner now alleges that "no evidence exists in the record that [the 25 percent] rule exists" (Br. 22). He overlooks that he himself asserted the existence of that rule in his application to the referee (A. 29a). At one point in this litigation petitioner contended that the 25 percent rate was too high. He appears to have abandoned that contention. In any event, the combined 25 percent rate is not unreasonable. Income withholding tax rates under Section 3402 range from 14 to 36 percent; the FICA withholding rate under Section 3101(a) and (b) is currently 5.85 percent.

[8] As we indicated above (p. 22, *supra*), the trustee is required to supply only the name and Social Security number of the wage claimant, his gross and taxable FICA wages paid, and the amount of federal income and FICA taxes withheld. The trustee necessarily secures all this information in the course of verifying the wage claim and calculating the tax. (The employment records of the bankrupt estate should include the claimant's Social Security number, but the claimant is in any event required to supply that number on his proof of return. See Form 16, Official Bankruptcy Forms.)

be and usually are filled out by a payroll clerk, bookkeeper, or other clerical employee" (A. 79a).[9]

Moreover even if the withholding and reporting requirements of the Code were shown to be burdensome, petitioner's obligation to withhold and report would not thereby be excused. Cf. *Swarts* v. *Hammer*, 194 U.S. 441, 444. The extent to which bankrupt estates should be exempted from the responsibilities imposed upon other taxpayers is a matter of legislative judgment and discretion; although the Code relieves some insolvents from certain specific tax liabilities,[10] Congress has expressly provided that bankruptcy trustees are otherwise subject to the same taxes as ordinary business taxpayers. 28 U.S.C. 959. See, *e.g.*, *Boteler* v. *Ingels*, *supra*. See, also, *United States* v. *Sampsell*, 266 F. 2d 631 (C.A. 9). In contrast, nothing in the Bankruptcy Act or the Code, either expressly or by fair implication, exempts bankrupt estates and their trustees from the duty to withhold and report. The reasons for this are obvious. Since the wage claim payments are "wages" for Social Security Act purposes (see p. 21, *supra*), the trustee's failure to withhold and report FICA taxes (1) could deny the employee the Social Security credit to which he is entitled under that Act and (2) would deprive the United States of the payment necessary to fund that credit.

[9] Moreover, we have been informed by the Service that its practice is to assist bankruptcy trustees and other fiduciaries in the preparation of these forms where such assistance is requested.

[10] Section 7507 exempts insolvent banks from the income tax; Section 108(b) exempts insolvent railroads from the recognition of income from the forgiveness of indebtedness; Sections 371 and 372 provide for tax-free reorganizations of certain bankrupt estates.

Similarly, failure to withhold income taxes from the wage payments would frustrate *pro tanto* the purposes of the income tax withholding provisions, which are to ensure timely collection of the tax and to assist individuals in making prompt payment.

Furthermore, petitioner's argument finds no support in either the Bankruptcy Act or the general policies that underlie it. Nothing in that Act relieves the trustee from his duty to withhold and report. Petitioner apparently relies upon his general obligation to conserve the assets of the bankrupt estate and protect its interests. But that obligation, which is little different from that imposed on other fiduciaries, does not override affirmative statutory responsibilities.[11]

[11] Petitioner further contends (Br. 19) that withholding taxes on priority wage claims are barred as penalties under Section 57j of the Bankruptcy Act. This contention is wholly without merit. Section 57j provides that debts owing from the bankrupt to the United States "as a penalty or forfeiture shall not be allowed." As we show below (pp. 28–30, *infra*), withholding taxes are not debts owing by the bankrupt. Moreover, the federal income and FICA withholding taxes imposed by Sections 3101 and 3402 of the Code are in no sense penalties or forfeitures. It is true that if the trustee fails to withhold he may become personally liable for a penalty equal in amount to the withholding taxes. See Section 6672 of the Code. But Section 57j of the Act does not purport to protect the trustee personally from the assessment of penalties resulting from his maladministration of the estate; it applies only to penalties payable out of the estate. See generally 3 Collier, *Bankruptcy*, ¶ 57.22.

II

THE UNITED STATES IS NOT REQUIRED TO FILE PROOFS OF CLAIMS WITH RESPECT TO WITHHOLDING TAXES ON PRIORITY WAGE CLAIMS

A. THE BANKRUPTCY ACT DOES NOT REQUIRE THE FILING OF PROOFS OF CLAIMS WITH RESPECT TO SUCH TAXES

Petitioner contends (Br. 11–13) that the United States must file proofs of claims under Section 57 of the Bankruptcy Act with respect to income and FICA withholding taxes on priority wage payments. In so contending, petitioner fails to make a necessary distinction between the liabilities of the bankrupt and those of the estate.

The "bankrupt" is the debtor—the person who files a voluntary petition in bankruptcy or against whom an involuntary petition is filed. Section 1(4) of the Act. The filing of the petition places the bankrupt's nonexempt property, its "estate," under the custody of the bankruptcy court. See Section 2 of the Act. The trustee, upon his appointment and qualification, is vested with title to the estate. Section 70 of the Act. The primary purpose of a bankruptcy proceeding is to provide for the orderly and equitable distribution of the estate among the bankrupt's creditors. However, during the course of administration the estate also incurs its own liabilities. The Bankruptcy Act treats the estate's liabilities and those of the bankrupt very differently.

The bankrupt's liabilities are satisfied, in full or in part, through the procedure of proving and allowing claims, a procedure that begins with the filing of proofs of claims. Section 57n of the Act requires that

"all claims provable under the Act * * * shall be proved and filed * * * within six months after the first date set for the first meeting of creditors." Section 63 further specifies that the claims provable under the Act are the "[d]ebts of the bankrupt." Thus unsecured creditors of the bankrupt must file formal proofs of claims in order to participate in the distribution of the assets of the estate. In contrast, the estate's creditors—creditors asserting debts of the estate rather than of the bankrupt—are not required to file proofs of claims. See generally 3 Collier, *Bankruptcy*, ¶ 57.34; 3A Collier, *Bankruptcy*, ¶ 63.03. Those claims may be paid by the trustee, upon the referee's order, without the filing of formal proofs. Thus whereas obligations of the bankrupt are paid on the basis of distributive shares after proof and allowance of claims, obligations incurred by the estate are generally separately payable as expenses of administration. See *Reading Co.* v. *Brown*, 391 U.S. 471.

In contending that proofs of claims were required with respect to the withholding taxes here, petitioner therefore is necessarily asserting that those taxes are liabilities that have been or will be incurred by Freedomland, the bankrupt, and not merely by the estate in the course of administration. But petitioner concedes (Br. 15–16), as he must, that the withholding taxes were not legally due and owing by Freedomland at the time of the adjudication of bankruptcy. Withholding taxes arise only when the wages are paid, not at the earlier time when they first accrue. See, *e.g.*, 26 C.F.R. 31.3402(a)–1(b) (providing that "[t]he employer is required to collect the tax by deducting

and withholding the amount thereof from the employee's wages *as and when paid"*; emphasis added).[12] It is therefore clear that Freedomland had incurred no liability for the withholding taxes at the time it was adjudicated a bankrupt.

Petitioner claims, however, that Freedomland was contingently liable for the taxes at the time of bankruptcy and therefore that the government's claims for those taxes were provable as "contingent debts" of the bankrupt under Section 63a(8) of the Bankruptcy Act. But although Freedomland would have been liable for the taxes if it had paid the wages, it was not, as bankrupt, contingently liable for taxes that would arise only upon payment of the wage claims by the trustee; petitioner confuses the separate liabilities of the estate and the bankrupt. That same confusion also underlies the ruling on this point in *In re Connecticut Motor Lines, supra,* on which petitioner relies. As we have shown above (pp. 18–20, 21, *supra*), the person who pays the wages is the one responsible for collecting and paying over the taxes. Petitioner apparently assumes that the bankrupt, as the employer at common law, necessarily becomes liable for payment of the withholding taxes upon the trustee's payment of the wages; but the common-law employer is liable for those taxes only if it "control[s] * * * the payment of * * * wages" (Section 3401(d)(1) of the Code), and the common-law employer here lost control

[12] The tax also arises upon constructive payment of the wages, but constructive payment requires, *inter alia*, that the wages "be made available to [the employee] so that they may be drawn upon at any time * * *." 26 C.F.R. 31.3402(a)-1(b). No question of constructive payment is involved here.

of the payment of wages upon the adjudication of bankruptcy. It is petitioner, acting on behalf of the estate (see note 4, *supra*), who is now responsible for paying the wages; accordingly, the withholding taxes arise as liabilities of the estate, not of the bankrupt. For example, a failure by petitioner to withhold or pay over the taxes could give rise to the assessment of a civil penalty against him personally (see note 11, *supra*), but it would not give rise to any liability on the part of the bankrupt. Thus the withholding taxes here are in no sense "[d]ebts of the bankrupt," contingent or otherwise.

The distinction drawn here between debts of the bankrupt and debts of the estate is not merely technical; it is central to the Bankruptcy Act's organizational scheme. Provability is linked to dischargeability under the Act: "provable" debts are debts from which the bankrupt is released by a discharge in bankruptcy. See Section 17 of the Act. A bankrupt does not need to be released from debts—such as the claims for withholding taxes here—for which third parties are exclusively liable. The Act therefore requires no "proof" of such debts under Section 57. We believe that these general considerations illustrate the fundamental nature of petitioner's error in relying upon Section 63a(8), which permits proof of the bankrupt's "contingent debts." That provision was enacted in 1938 for the purpose of granting additional relief to bankrupts: debts that formerly had survived bankruptcy as personal obligations of the bankrupt were made subject to proof and release. See generally 3 Collier, *Bankruptcy*, ¶ 57.15; 3A Collier, *Bankruptcy*,

¶ 63.30. Thus both the specific language and the purpose of that provision restrict its application to "[d]ebts of the bankrupt;" it can have no application to claims, such as those here, for which the bankrupt would never be liable anyway. Certainly Section 63a(8) was not intended to interpose procedural obstacles to the enforcement of the separate liabilities of the estate.

B. THE FILING OF PROOFS OF CLAIMS WITH RESPECT TO SUCH TAXES WOULD BE IMPRACTICAL AND WOULD SERVE NO PURPOSE

Practical considerations reinforce the foregoing statutory analysis. The filing of a proof of claim is a ministerial act intended to incorporate the proof into the records of the court. See 3 Collier, *Bankruptcy*, ¶57.10. The purpose of the filing is to apprise the trustee and other creditors of the claims outstanding against the bankrupt. But the filings of proofs of priority wage claims apprise all parties of the total amounts, including distributions of withholding taxes, that may be payable on account of those claims: withholding taxes are payable out of the employees' distributive share and do not further reduce the amounts available for payment to other creditors. And the trustee and the employees need not be additionally apprised, through the filing of proofs of withholding tax claims, of a duty to withhold that is already prescribed by statute. Thus the court of appeals below was correct in observing (A. 16a):

> The filing of the wage claims by the individuals constructively constituted a claim by the taxing authorities for withholdings due by law. Other creditors are not misled, since the amounts claimed for wages include within them the amounts due to the taxing authorities.

Our argument is not, as petitioner assumes (Br. 12), that proofs of claims may be "constructively" filed; to the contrary, as we have shown above (pp. 27–31, *supra*), no filings of such proofs are required at all. But the point here is simply that filings of such proofs would in any event serve no purpose under the Bankruptcy Act.

Moreover, the filings of proofs of claims for withholding taxes on priority wage claims is not practicable. Petitioner apparently acknowledges (Br. 11) that proofs of claims for such taxes could not be filed within the six-month period prescribed by Section 57n. At a minimum, such proofs would have to state the total amount of priority wage claims outstanding, and that figure cannot be known until after the close of the six-month filing period. In addition, the tax claims themselves are not computable before the order allowing wage payments is entered by the referee: determination of the tax requires knowledge of both the effective rates of tax and the amount of actual wage payments.[13] Petitioner suggests (Br. 11) that these practical difficulties could be surmounted by having the referee grant extensions of time for filing the proofs. But since the tax is not computable until the wage payments are ordered, an extension to and

[13] Since the effective rates of tax cannot be finally determined until the wage payments are made, petitioner errs in contending (Br. 11) that the government could, at the expiration of the six-month filing period, "compute the total maximum amount of taxes that would be involved." In any event, since the taxes are ultimately payable out of the employees' shares, it is difficult to see in what way a preliminary maximum tax computation would be relevant to the trustee's performance of his administrative responsibilities.

including the date of the order of payment would be required; petitioner's suggestion that such an extension would be acceptable is thus tantamount to an admission that the filing of proofs of such claims is not necessary to bankruptcy administration and would be required, under petitioner's reading of the Act, purely as a matter of form. Furthermore, the granting of such extensions under Section 57n is discretionary with the referee; we see no reason, and petitioner suggests none, why Congress would have imposed a purely formal but mandatory filing requirement upon the government and then left the government's ability to satisfy that requirement dependent upon the discretion of the referee.

In short, the filing requirement petitioner would impose is both impracticable and unnecessary. It is contrary to the plain language of the Act and furthers no legitimate interest of either the creditors, the bankrupt, or the trustee.

III

WITHHOLDING TAXES ON PRIORITY WAGE PAYMENTS ARE FIRST PRIORITY DEBTS UNDER SECTION 64a OF THE BANKRUPTCY ACT

We do not believe that the withholding of federal income and FICA taxes from priority wage payments should ordinarily give rise to any question of priority under Section 64a of the Bankruptcy Act. Section 7501 of the Code imposes upon employers and other persons liable for the collection of taxes a general obligation to hold withholding taxes as "a special fund in trust for the United States." Thus where the

trustee in bankruptcy complies with the command of Section 7501, the withholding taxes are payable as a trust fund to the United States without regard to the priorities established by the Bankruptcy Act. See 3A Collier, *Bankruptcy*, ¶64.02[3]. Cf. *Nicholas* v. *United States, supra*, 384 U.S. at 690–691.

There is, however, no Section 7501 trust fund in this case. Although petitioner has now paid the priority wage claims and withheld the federal income and FICA taxes, this was done pursuant to an agreement, entered into following the court of appeals' decision, that the rights of the parties in this litigation would not thereby be affected. We concede that this agreement bars the United States from contending that petitioner has established a trust fund under Section 7501.

The issue that arises, therefore, is to what priority of payment, if any, the United States is entitled with respect to the withholding taxes in this case. Decision of this issue requires determination of whether the withholding taxes are entitled to one of the priorities granted by Section 64a of the Act: with the exception of secured debts and debts represented by trust funds, debts in bankruptcy are payable only as general unsecured claims unless they fall within one of the five priority categories established by Section 64a.[14]

[14] Only two priority categories are actually at issue here. The parties agree that the third, fourth, and fifth priorities are inapplicable. The district court, following *In re Connecticut Motor Lines, supra*, held that the withholding taxes here are entitled to fourth priority under Section 64a(4) as taxes "which became legally due and owing by the bankrupt." However, as we have shown above (pp. 28–30, *supra*), the withholding taxes on priority wage payments never be-

The positions of the parties, and the decisional authority on which they rely, may be briefly summarized. Petitioner contends (Br. 13–19) that withholding taxes on priority wage payments are not within any of those priority categories and therefore are payable as general unsecured claims.[15] No case authority supports that contention.[16] The City of New York urges (Br. 22–27) that such withholding taxes constitute "wages and commissions" entitled to second-priority treatment under Section 64a(2). No case

come legally due and owing by the bankrupt, only by the estate. Moreover, liability for the withholding taxes here arises only after bankruptcy (see (pp. 28–29, *supra*), whereas Section 64a(4) applies only to taxes that become due prior to bankruptcy. See generally 3A Collier, *Bankruptcy*, ¶ 64.401. These withholding taxes are not even computable prior to bankruptcy (see p. 32, *supra*). Cf. *In re International Match Corporation*, 79 F. 2d 293 (C.A. 2), certiorari denied *sub nom. Delaware* v. *Irving Trust Co.*, 296 U.S. 652. Of course, if this Court concludes, contrary to our contentions, that the withholding taxes here are debts of the bankrupt and that the obligation to pay accrues prior to bankruptcy, those taxes should be accorded fourth-priority treatment. See *In re Connecticut Motor Lines*, *supra*. See generally 3A Collier, *Bankruptcy*, ¶64.405[1].

[15] Underlying petitioner's contention is the assumption that the taxes are debts of the bankrupt, for only "allowed claims" are payable as general unsecured claims under Section 65 of the Act, and only "[d]ebts of the bankrupt" are subject to proof and allowance under Section 63.

[16] Petitioner cites *In re John Horne Company*, 220 F. 2d 33 (C.A. 7), and *Pomper* v. *United States*, 196 F. 2d 211 (C.A. 2), but these cases involved withholding and employer's taxes on wages actually paid prior to bankruptcy. As we have indicated above (pp. 13–14, *supra*), the government recognizes that such taxes are legally due and payable prior to bankruptcy and therefore are entitled only to fourth-priority treatment unless a trust fund has been established pursuant to Section 7501 of the Code. See *United States* v. *Randall*, *supra*.

authority, other than the decision below, supports the City's contention. The United States contends here, as it did below, that the withholding taxes in question are first priority "costs and expenses of administration" under Section 64a(1).[17] This contention finds direct support in the decisions of three courts of appeals. See *United States* v. *Fogarty, supra; United States* v. *Curtis, supra; Lines* v. *California Department of Employment, supra.*

Because withholding taxes on priority wage claims are payable out of the employees' share of the estate, collection and payment of such taxes does not reduce the fund available for distribution to creditors hold-

[17] This issue is properly before the Court. Although the court of appeals rejected the first-priority argument, under its decision the United States would have received full payment of its withholding tax claims, for there are sufficient assets in the estate to satisfy all second-priority claims in full. The United States therefore had no practical basis for seeking further review and for that reason did not file a petition for a writ of certiorari. But petitioner properly recognizes, in both his statements of the questions presented (Pet. 2; Br. 3) and his briefing of the priority issue (Br. 13–19), that this Court necessarily must determine whether the withholding taxes here are excluded from every priority category under Section 64a, including the first priority, in order to decide the issue he raises. For this reason, this case does not present the cross-petition problem of *Strunk* v. *United States*, 412 U.S. 434, *Brennan* v. *Arnheim & Neely, Inc.*, 410 U.S. 512, and *National Labor Relations Board* v. *International Van Lines*, 409 U.S. 48. Moreover, even if the question of first priority were separable from that of nonpriority, which it is not, the first-priority issue in this case would be within this Court's discretionary jurisdiction, especially in view of the fact that our argument on that issue supports the actual asset distribution ordered by the court of appeals. See generally Stern, *When to Cross-Appeal or Cross-Petition—Certainty or Confusion?*, 87 Harv. L. Rev. 763 (1974).

ing lower-priority or general unsecured claims. In this sense, such withholding taxes are analogous to expenses chargeable to funds or parties other than the estate. See 3A Gollier, *Bankruptcy*, ¶ 62.33. Thus no creditors are harmed by payment of the taxes as priority debts: the employees from whose wages the taxes are withheld receive credits for both federal income tax and Social Security purposes (see, *e.g.*, Section 31 of the Code and Section 205(c) of the Social Security Act, 42 U.S.C. 405(c)), and other creditors are left in the same position as if there had been no withholding at all.

In contrast, treatment of such taxes as general unsecured claims would confer an unjustifiable windfall upon other creditors where the estate is insufficient to satisfy all claims: although the United States would be charged with the receipt of the taxes for income tax and Social Security purposes, actual payment of the withheld amounts would be made to other creditors. In this case, for example, due to the insufficiency of the estate, treatment of the withholding taxes as general unsecured claims would result in distribution of the withheld amounts to fourth-priority creditors; nothing would remain for distribution to the United States as a general unsecured creditor. That result is completely unreasonable; it places the United States in a worse position than if there had been no withholding. We therefore believe that treatment of withholding taxes on priority wage payments as nonpriority debts would be both inequitable and irrational. Moreover, as we now show, it is not the treatment accorded by the Bankruptcy Act.

The priority for "costs and expenses of administration" under Section 64a(1) of the Act both applies by its terms to the withholding taxes here and meets the practical needs of bankruptcy administration. The withholding taxes that arise upon payment of priority wage claims in bankruptcy are necessary costs incurred in the course of administering the estate. As such, they fall well within the broad category of "costs and expenses of administration" under the Act. See generally 3A Collier, *Bankruptcy*, ¶ 64.105.

Petitioner's only argument against treatment of the withholding taxes as first priority debts is that "costs and expenses of administration" under Section 64a(1) covers only "the preservation or development of the bankrupt's assets" (Br. 17). This argument is refuted, however, by the genesis and history of that Section, as well as its language. Under Section 64 of the 1898 version of the Bankruptcy Act, the "actual and necessary cost of preserving the estate subsequent to filing the petition" was accorded priority over "the cost of administration." See 3A Collier, *Bankruptcy*, ¶ 64.01[2].[18] But Section 64 was amended in 1938 (52 Stat. 874) and that amendment "grouped [together] all of those claims which arise from the preservation and administration of the bankrupt's estate" into the first priority category. 3A Collier, *Bankruptcy*, ¶ 64.01 [3.1]. And in 1962, that provision was further amended (76 Stat. 571) to make explicit that "costs

[18] *Adair* v. *Bank of America Association*, 303 U.S. 350, upon which petitioner relies, was decided under the 1898 Act; the Court in that case merely observed that since the costs there in question were costs of preserving the estate, they were of course entitled to first priority of payment.

and expenses of administration" embraces, but is not limited to, costs of preserving the estate: Section 64a (1) now reads "the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition * * *".[19] Thus it is now well understood that a wide variety of administrative expenses, bearing no relationship to the preservation of the estate, are entitled to first-priority treatment. See 3A Collier, *Bankruptcy*, ¶ 64.105. In particular, the salaries paid to clerical assistants in connection with validating wage claims and making distributions to claimants, and the mailing expenses incurred in making payment, are administrative expenses entitled to first priority of payment even though they are not costs of preserving the estate. See, *e.g.*, *In re Public Ledger*, 161 F. 2d 762 (C.A. 3). Cf. *Reading Co.* v. *Brown*, *supra*. The withholding taxes that arise upon the payment of those wage claims should be treated in the same manner.

We urge first-priority treatment of such withholding taxes for two reasons: (1) that treatment is the only means of assuring that such taxes will be paid in full; (2) it is, moreover, the only administratively feasible treatment of those taxes. We believe that both these points are illustrated by the following hypothetical.

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[19] "[T]he actual and necessary costs and expenses of preserving the estate subsequent to filing the petition" historically has principally applied to expenses incurred by a receiver in bankruptcy pending adjudication of bankruptcy and appointment of the trustee, whereas the trustee's expenses ordinarily are costs of administration rather than of preservation. See 3A Collier, *Bankruptcy*, ¶ 64.102.

Assume that a trustee in bankruptcy determines that after making allowance for all reasonably foreseeable first priority administrative expenses (excluding withholding taxes on priority wage payments), only $20,000 will remain in the estate, and that priority wage claims in the gross amount of $40,000 have been validated; assume further that the trustee chooses to withhold federal income and FICA taxes at the combined flat rate of 25 percent. Under these assumptions, *pro rata* distribution of the wage claims and collection and payment of the withholding taxes is extremely simple if the taxes are accorded first-priority treatment: each second-priority wage claim will be entitled to a 50 percent payment; thus the claims will be satisfied in the gross amount of $20,000, consisting of $15,000 net wages and $5,000 withholding taxes; the withholding taxes will be payable in full as first-priority debts. In contrast, according withholding taxes only a second priority would complicate the distribution process considerably and result in nonpayment of a portion of the taxes: the wage claims would initially be satisfied in the gross amount of $20,000, consisting, as before, of $15,000 net wages and $5,000 withholding taxes; but the withholding taxes, as second-priority debts, would be entitled only to a 50 percent distribution of $2,500; this would leave $2,500 in the estate to be distributed *pro rata* among second-priority claimants asserting debts of $22,500 ($20,000 of unsatisfied wage claims and $2,500 of unpaid withholding taxes); thus a second distribution of approximately 11.1 percent would be required; under the second distribution gross wage

payments would be made in the approximate amount of $2,222, consisting of $1,667 net wages and $555 withholding taxes; however, of the total withholding tax claim of $3,055 ($2,500 left unpaid from the first distribution and $555 arising upon the second), only $339 (11.1 percent) would actually be paid; thus the total amount actually distributed in the second round of distributions would be $2,006 ($1,667 net wages plus $339 withholding taxes), leaving $494 in the estate still to be distributed among claimants asserting second-priority debts in the aggregate amount of $20,494 ($17,778 of unsatisfied wage claims and $2,716 of unsatisfied withholding tax claims); and so, additional distributions would be required in a decreasing but infinite series that could be accurately expressed only by algebraic formula. The approximate working out of this hypothetical is summarized in the following table:

	Treatment of withholding taxes	
	First priority	Second priority
Amount actually available for distribution	$20,000	$20,000
Wage distributions:		
Gross wages	20,000	22,767
Less: withholding taxes	5,000	5,692
Net wages	15,000	17,075
Withholding tax payments	5,000	2,925
Total distributions	20,000	20,000
Net Unsatisfied Withholding Tax Liability	0	2,767

We do not believe that bankruptcy administration was intended to be burdened by the complex calculations that would be necessary if withholding taxes on priority wage payments were themselves treated as second-priority debts. Nor do we believe that the effective redistribution of withheld amounts to employees that would result from such treatment accords with the purpose and intent of the withholding provisions of the Internal Revenue Code.[20]

In our response to the petition for a writ of certiorari, we also argued for first-priority treatment on the ground that "after the distribution of wages, but before payment of the taxes, the estate may incur other administrative expenses which [otherwise] would have priority over such taxes" (Memo. 7–8, n. 7). Upon further consideration we have concluded that although this argument is technically correct, subsequently incurred administrative expenses are in fact unlikely to result in nonpayment of accrued withholding taxes. A conscientious and responsible trustee, before securing an order for distribution to lower-priority claimants, will set aside sufficient funds to satisfy all reasonably foreseeable administrative expenses. Moreover, contrary to the contention of the City of New York (Br. 27), this common proce-

[20] We acknowledge that these difficulties arise only when there are sufficient funds to pay only a portion of the second-priority wage claims. In other circumstances it should make no difference whether the withholding taxes are paid as first-priority or second-priority debts. If there are ample assets in the estate to satisfy all second-priority claims, the taxes will be paid in full under either priority category. And if the assets are insufficient to make payment of any second-priority debts, the taxes will never arise (see pp. 28–29, *supra*).

dure does not involve "an insoluble mathematical problem" where—as has long been the case in the Sixth, Eighth, and Ninth Circuits—withholding taxes on priority wage payments are treated as first-priority debts. Indeed, the "problem," if any, that is posed in this connection by such withholding taxes is considerably simpler than that posed by ordinary administrative expenses, such as the salaries of clerical assistants. Those other expenses must at least be estimated for the purpose of setting aside a reserve fund, whereas the trustee may safely ignore withholding taxes for that purpose because such taxes only arise upon payment of the wage claims (pp. 28–29, *supra*) and are payable out of the employees' gross share of the estate.

This close relationship between the wage claims and the withholding taxes lends a superficial appeal to the contention of the City of New York (Br. 23–27) that the taxes should be treated as second-priority debts. But, as we have shown, such second-priority treatment is unsatisfactory both from the viewpoint of effective federal tax collection and that of efficient and sensible administration of estates in bankruptcy. Moreover, that treatment would require a somewhat strained reading of the statute. Section 64a(2) of the Bankruptcy Act creates a priority for "wages and commissions * * * due to workmen." Certainly the employees' gross wage claims, encompassing amounts to be withheld as taxes, are claims for "wages" under that provision. But it is the character of the United States' claims that is here in question. Those claims are not

for "wages * * * due to workmen" but for taxes due under Sections 3402 and 3101 of the Code. Cf. *Joint Industry Board* v. *United States, supra*; *United States* v. *Embassy Restaurant, supra.* Those claims do in a sense derive from the wage claims, but they are statutorily-based and have a separate and distinct legal status of their own; there is nothing strange, anomalous, or illogical about giving due recognition to that separate status under the Bankruptcy Act. To the contrary, it is only by recognition of their status as first-priority administrative expenses that the Act can be equitably and efficiently administered.

CONCLUSION

The judgment of the court of appeals should be affirmed insofar as it holds (1) that petitioner must withhold federal income and FICA taxes from payment of wage claims made under Section 64a(2) of the Bankruptcy Act and prepare and submit to the wage claimants and the Internal Revenue Service appropriate information reports and returns with respect to the amounts withheld and (2) that the United States is not required to file a proof of claim with respect to such withholding taxes. The judgment of the court of appeals should be modified insofar as it holds that such withholding taxes are payable as

second-priority rather than first-priority debts under Section 64a of the Act.

Respectfully submitted.

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JULY 1974.

U.S. GOVERNMENT PRINTING OFFICE: 1974